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SUMMARY OF CONSULTATION PAPER: CP7/22 CREDIT UNIONS: CHANGES TO THE REGULATORY REGIME (SEPTEMBER 2022)

Summary of proposals

- To include lending to corporate members and the provision of consumer credit within the definition of 'additional activities,' with the effect of bringing credit unions undertaking these activities within the scope of existing additional systems and control requirements;

- to extend the range of products available to credit unions to invest in, to include a wider range of products, where a credit union meets certain requirements. This also includes clarification that credit unions may hold funds with other credit unions, as clarified by recent changes in legislation; and

- amendments to the PRA rules on lending limits, including confirmation that the current limits on credit union unsecured lending will also apply to the provision of hire purchase agreements and conditional sale agreements, which will be permitted products for Great Britain credit unions under the FS Bill's proposed amendments to the Credit Unions Act 1979.

The key proposed changes included in the proposed Supervisory Statement (SS) are:

- To set additional expectations for credit unions with more than £10 million in assets with respect to liquidity risk management and contingency funding, with a further expectation for credit unions with more than £50 million in assets and/or credit unions that wish to undertake more sophisticated investment business as per the above, to undertake basic liquidity stress testing;

- to provide more clarity on PRA expectations regarding the amount and quality of capital held by a credit union;

- to set out additional detail on PRA expectations of credit unions that offer mortgages, including consideration of relevant sections of SS20/15 'Supervising building societies' treasury and lending activities'2 as evidence of good practice;

- to set an expectation that the largest credit unions (with more than £100 million in assets) consider the steps and resources needed to wind down their business in an orderly manner and can evidence that they have evaluated the risks and how best to mitigate them;

- to set expectations for credit unions that provide credit cards;

- to set expectations for credit unions that provide loans to corporate members. This includes minimum expectations for credit unions undertaking secured lending to corporate members;

- to set expectations around risk management, including operational risk management for credit unions with more than £10 million in assets, with good practice guidance for all credit unions;

- to clarify existing expectations for all credit unions on governance, business plans, and forecasts; and

- to set expectations regarding a credit union's internal audit function, including indicators that it may not be fulfilling its role

Proposals

Proposed changes to the Credit Unions Part of the PRA Rulebook

Extending the definition of additional activities

- Market The PRA proposes to extend the definition of 'additional activities' in the glossary of the Credit Unions Part of the PRA Rulebook, to include lending to corporate members and the provision of consumer credit.

- Credit unions that have more than 15,000 members or undertake 'additional activities' are subject to an additional layer of requirements. Credit unions opting to undertake one or more of these additional activities must meet additional systems and controls requirements (Rule 10.3 in the Credit Unions Part of the PRA Rulebook) and are expected to meet additional expectations set out in the proposed SS.

- Given the additional risks involved in the provision of loans to corporate members and consumer credit, their inclusion within the definition ensures credit unions undertaking these activities would be subject to existing additional systems and controls (Credit Unions 10.3) requirements.

- The PRA considers that the proposal is consistent with the regulatory principle that a burden which is imposed should be proportionate to the expected benefits, and the principle that the differences in the nature and objectives of different business models should be recognized.

Extending the range of credit union permitted investments.

- The PRA proposes to extend the range of permitted investments to include a wider range of products, where a credit union is meeting certain requirements.

- Chapter 6 of the Credit Unions Part of the PRA Rulebook provides credit unions with a limited range of options when investing their surplus funds. Capital protection is at the heart of this principle. The PRA considers that some credit unions struggle to find enough high rated counterparties willing to accept credit union funds, and feel pressured to spread concentration risk and may feel obliged to place funds with lower-rated institutions.

- The PRA considers any changes to the credit union investment framework should reflect the fact that it is the savings of members (which can be withdrawn on demand) that will be invested. The PRA therefore considers it appropriate to focus on the low end of the risk spectrum, concentrating on fixed income investments, and investments with characteristics that will ensure appropriate levels of investment and liquidity management risk.

- The PRA proposes to expand the range of products available to credit unions to invest in, which will include a wider range of products including: corporate bonds, undertaking for collective investment in transferable securities (UCITS), qualifying money market funds and supranational bonds. The PRA proposes to implement this by extending the allowable investments under Rule 6.4 of the Credit Unions Part of the PRA Rulebook. A credit union may only hold Credit Unions 6.4 investments if it complies with Credit Unions 10.3 requirements.

- The PRA recognizes that this would move the emphasis away from capital protection, which would be a step change, and in order to minimize any corresponding risks it proposes to put in place the following safeguards:

    1. *Corporate bonds must be traded on a UK regulated-exchange and must be investment grade or higher rated by at least two recognized agencies.*

    2. *UCITS and money market funds must be regulated in the UK and have a minimum asset size of at least £100m total assets, and be composed of instruments permitted under credit union rules with a credit rating of investment grade or higher, by at least two recognized credit rating agencies that are registered in the UK.*

    3. *Supranational bonds must be investment grade or higher, rated by at least two recognized agencies.*

    4. *A 5% counterparty limit is proposed for credit union's capital invested directly in corporate bonds or supranational bonds, with a single counterparty, and no more than 30% of total capital resources to be invested cumulatively in the new investment classes (corporate bonds, UCITs, money market funds and supranational bonds).*

    5. *Rules 6.5 and 6.6 in the Credit Unions Part of the PRA Rulebook requires that credit unions investing surplus funds must consider and document their decision and account for counterparty, concentration, and liquidity risk. Given its consideration that the liquidity transformation risk of credit union holdings of longer duration and potentially more complex instruments, the PRA proposes to link the expanded range of investments to additional liquidity guidance, including the expectation that credit unions holding such investments undertake basic liquidity stress testing (see paragraph 2.16).*

- The PRA also proposes to clarify in the SS that credit unions with over £10 million in assets should be expected to meet investment counterparty and concentration limits in relation to the existing investment products. This includes an expectation that an amount equivalent to no more than 75% of a credit union's total capital should be held with a single counterparty.

- The FS Bill proposed amendments to the Credit Unions Act 1979 including confirmation that Great Britain credit unions may hold funds with other credit unions. In line with this, the PRA proposes to clarify in Credit Unions 6.3 that funds placed with other credit unions are permitted investments.

Amendments to Chapter 3 of the Credit Unions Part

- The PRA proposes amendments to confirm that the current limits on credit union unsecured lending will also apply to the provision of hire purchase agreements and conditional sale agreements, which will be permitted products for Great Britain credit unions under the FS Bill's proposed amendments changes to the Credit Unions Act 1979.

- The PRA also proposes amending Rules 3.4 and 3.5 of the Credit Unions Part of the PRA Rulebook to clarify that the lending limits specified apply to the aggregate total of outstanding loans of a member (or another credit union) to a credit union, rather than a single loan.

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Proposed Credit Union Supervisory Statement and superseding of Supervisory Statement

- The PRA proposes to introduce a new credit union SS 'Supervising Credit Unions' as set out in Appendix 2 of "The prudential regulation of credit unions". The PRA proposes that the expectations set out in its existing SS2/16 will be superseded by the new SS, and SS2/16 will be deleted.

Liquidity

- Credit unions are required to maintain a board-approved liquidity management policy under Credit Unions 10.5. The PRA proposes to clarify basic liquidity management expectations for all credit unions in the SS. Credit unions with more than £10 million in assets would be expected by the PRA to maintain a board-approved liquidity management policy that sets out their strategy for liquidity risk management, and how they would address liquidity shortfalls in an emergency.

- Further, the PRA proposes to set an expectation that credit unions with total assets of more than £50 million (currently circa 18 credit unions) and/or credit unions that wish to undertake more sophisticated investment business to undertake basic liquidity stress testing. Ideally this would be calibrated based on historic data, where such data is available to credit unions at a sectoral level.

- Current credit union liquidity rules require credit unions to hold a minimum of 10% of their callable deposits in funds/instruments they can access within eight days. Unlike other liquidity regimes, the regime does not assess stressed outflows. SS2/16 makes no material reference to what the PRA considers to be good liquidity practice.

- The PRA is proposing to introduce additional expectations of the larger credit unions, where a liquidity disruption would have a greater impact, and where the credit unions are more capable of implementing more complex requirements.

Capital

The PRA proposes to set several additional expectations with respect to the amount and quality of capital held by a credit union:

1. It expects credit unions to consider whether additional capital should be held over and above the credit union's minimum requirement, in order to meet Rule 8.1 of the Credit Union Part of the PRA Rulebook.
2. It proposes to set an expectation that, in circumstances where there are specific risks present (e.g., high risk business models, governance concerns etc.) and a credit union has not taken up the PRA's invitation to apply for a 'voluntary requirement' (VREQ), credit unions should expect that supervisors will consider whether it is appropriate to impose an additional capital add-on. As with firms subject to Capital Requirements Regulations (CRR), the PRA has the capacity to set capital or require a certain quality of capital to be held by way of an OIREQ (assuming a credit union does not agree to do so voluntarily) in order to, for example, absorb unexpected reductions. This tool would be applied at the discretion of the supervisor and should not be expected as a matter of course if a credit union undertakes a certain activity.
3. It proposes to clarify that, except for credit unions that have been established for less than five years, it would not expect more than 50% of a credit union's capital base to be composed of

subordinated debt or interest-bearing deferred shares. Where the capital base of a credit union (that has been established for more than five years) exceeds this level, the PRA would expect to be notified of this, and of the credit union's plan to reduce their reliance on these sources of capital.

Mortgages

- The PRA proposes to set an expectation that credit unions that offer mortgages should, as evidence of good practice, consider relevant sections of SS20/15 'Supervising building societies' treasury and lending activities. The proposed draft SS in Appendix 2 of "The prudential regulation of credit unions" sets out more detail on the sections credit unions are expected to consider, and the PRA's expectation that they can evidence that they have considered the relevant risks, and put mitigating controls in place, where appropriate.

- There is no PRA-specific regulatory regime for credit unions offering mortgages at present. The PRA's supervision relies instead on principle-based supervision, and reference to best practice. If the PRA receives greater numbers of applications from credit unions seeking mortgage permissions (only five currently offer mortgages), the PRA will review the appropriateness of the regulatory framework (rules and SS), as it relates to mortgage lending.

Exit strategy planning

- The PRA proposes to include an expectation in the SS that the largest credit unions (i.e., those with more than £100 million in assets) consider the steps and resources needed to (i) wind down; and (ii) achieve a transfer of engagements in an orderly manner, with minimal negative effects on members. Credit unions would be expected to evidence that they have evaluated the risks and impact of a wind down/transfer and considered how best to mitigate them.

- Credit unions are not currently subject to recovery and resolution planning requirements (the sole requirement is to have an accurate Single Customer View). The PRA has considered whether this should continue to be the case for the larger and more complex credit unions (given banks and building societies of similar size are subject to such requirements).